

CLIENT UPDATE

RUSSIA'S WORLD TRADE ORGANIZATION COMMITMENTS IN THE AVIATION SECTOR

LONDON

Geoffrey P. Burgess
gpburgess@debevoise.com

MOSCOW

Alan V. Kartashkin
avkartashkin@debevoise.com

Dmitry A. Karamyslov
dakaramyslov@debevoise.com

Anastasia V. Aboeva
avaboeva@debevoise.com

Russia has finally joined the World Trade Organization and became a full member of the WTO on August 22, 2012. Russia was the last large economy to join the WTO, and its accession was a welcome step in the further liberalization of global trade. The accession was approved by way of adopting and signing of the Protocol on the Accession of the Russian Federation (the "Protocol"). Among other things, the Protocol also incorporates certain commitments of the Russian Federation set out in the respective Working Party Report¹ (the "Report").

Russia's WTO accession has the following key consequences for the Russian aviation sector:

- further relaxation of aircraft leasing and certification regulations;
- reduction of customs duties and taxes applicable to foreign aircraft; and
- possibility of receiving state subsidies for the leasing of aircraft produced by the foreign manufacturers.

In this update, we briefly describe the main aviation commitments of the Russian Federation in connection with its accession to the WTO and the first steps to implement them.

¹ These and other related WTO documents are available at:
http://www.wto.org/english/thewto_e/acc_e/a1_russie_e.htm

LEGAL STATUS OF WTO COMMITMENTS

Under Russian law, international treaties to which the Russian Federation is a party are deemed an integral part of the Russian legal system. Therefore, the WTO agreements which Russia has joined have direct effect in the Russian Federation. However, Russia's obligatory WTO commitments are limited by those described in paragraph 1450 of the Report and include, for example, commitments in respect of aircraft leasing and certification, but do not include certain commitments related to import and customs duties. The latter will be effective only when affirmatively implemented into Russian legislation and legislation of the Customs Union of Russia, Kazakhstan and Belarus.

At the same time, despite the urgent solicitations of many WTO members, Russia has not joined the Agreement on Trade in Civil Aircraft, which eliminates import duties on all aircraft (other than military aircraft), civil aircraft engines, flight simulators and components and parts. Currently, Russia has an observer status under this agreement and is not bound by its provisions.

CUSTOMS

Reduction in the amount of customs duties imposed on imported aircraft was one of the most anticipated changes in Russia as a result of WTO accession.

These expectations, however, were left unfulfilled as, firstly, customs duty reductions were part of the non-binding commitments and, secondly, changes were based on the rates existing several years ago when all foreign aircraft, without regard to weight and seat capacity, were subject to a 20% customs duty rate. Given that since then such customs duty rate in respect of certain aircraft has been decreased, customs duty rates for such aircraft may even increase. For example, jets with up to 50 passenger seats with a basic operating weight not exceeding 20,000 kg and large aircraft with more than 300 passenger seats are subject to an increase in the customs rate from 0% to 7.5%, 8% or 12.5%, depending on the characteristics of the aircraft.

The most beneficial regime will be granted to the wide-body aircraft.² Such aircraft will be subject to a 7.5% customs duty, which is the lowest customs rate for aircraft set forth in the Protocol. Currently, Russian customs law does not speak in terms of wide- or narrow-body,

² As 99% of such aircraft are manufactured by Airbus and Boeing, the lower rate for wide-body aircraft has been attributed to the lobbying efforts of these manufacturers.

so the introduction of this concept will require changes to the developed structure of the customs regulatory regime.

Russia has agreed on the gradual reduction of customs rates:

- after January 1, 2016, the rates will become 7.5% for all wide-body aircraft with basic operating weight exceeding 15,000 kg;
- after January 1, 2017, the rate in relation to passenger and cargo aircraft with basic operating weight from 2,000 kg to 15,000 kg will become 8%, the rate for the light (up to 2,000 kg) passenger aircraft will decrease from 20% to 10% and the rate for the light cargo aircraft will decrease from 20% to 15%; and
- after January 1, 2019, rates applicable to all other aircraft will become 12.5%.

The Protocol refers to 20% as the customs duty rate currently in force. The fact that such rate no longer applies to certain aircraft types was mentioned in the Report, but not reflected in the Protocol. Such reference to the 20% rate calls into question the current customs rate applicable before WTO rates will come into force,³ as well as various customs duty and VAT exemptions available in the Customs Union of Russia, Kazakhstan and Belarus. We note that the most recent Customs Union customs tariff, which entered into effect after WTO accession, on September 29, 2012, maintained the same beneficial customs duty rates applicable to aircraft as were in effect prior to WTO accession, even though, for example, the rate for high-grade paper, which was subject to a similar inconsistency, has increased to match the higher rate in the Protocol. As for the customs duty and VAT exemptions currently available in the Customs Union, those officials of the Customs Union Commission and the Russian Federal Customs Service whom we contacted believe that these exemptions contradict Russia's WTO commitments and must be cancelled. Currently, the exemptions still apply, but their fate remains to be seen.

AIRCRAFT LEASING AND SUBSIDIES

In order to promote the purchase of domestic aircraft, on June 26, 2002, the Russian Government enacted Resolution No. 466 ("Resolution 466"). Under Resolution 466, Russian airlines may apply for state support in the form of partial compensation of lease and loan payments spent on the purchase of Russian-manufactured aircraft. Only Russian-manufactured aircraft purchased by Russian leasing companies and financed by Russian banks qualified under this support program. WTO members argued that Resolution 466

³ There are different effective dates in relation to different types of aircraft starting from January 1, 2016. Please refer to the summary chart in Appendix hereto for details.

constitutes a prohibited subsidy under the WTO Agreement on Subsidies and Countervailing Measures because it encourages the purchase and lease of Russian-manufactured aircraft by lowering the leasing costs of such aircraft to Russian airlines.

Russia agreed to amend Resolution 466 prior to accession to the WTO and on December 12, 2011 the Russian Government enacted Resolution No. 1212, which provides application of subsidies to aircraft manufactured abroad. However, in order to qualify, a foreign-produced aircraft may not be more than 10 years old and have seat capacity over 72 seats for turboprop aircraft or over 55 seats for any other aircraft. Russian airlines “RusLine” and “AK Bars Aero”, leasing three and five Bombardier CRJ-200, respectively, and “Avia Group Management”, which plans to lease sixteen Pilatus aircraft for aerotaxi “Dexter”, are already benefiting from such subsidies.

FOREIGN INVESTMENT IN THE AVIATION SECTOR

Russian law imposes certain limitations on foreign participation in Russian companies operating in the aviation sector. According to the Russian Air Code, an aviation *enterprise*⁴ (this term includes an airline) may be established only if (a) the participation share of foreign capital does not exceed 49% of its charter capital, (b) its head is a Russian citizen and (c) the number of foreign citizens in its management body does not exceed one third of its total number.

The Federal Law “On State Regulation of Development of Aviation” used to contain similar restrictions. This law permitted establishment or participation in an aviation *organization*⁵ with the participation of foreign capital only if (a) the share of the participation of foreign capital is less than 25% of the aviation organization’s charter capital and (b) the manager and executive officers of such organization are citizens of the Russian Federation. Organizations involved in the operation of aircraft (airlines) were expressly excluded from these limitations. In 2008 such rules were superseded by the Federal Law “On the Procedure of Foreign Investment in Companies Having Strategic Significance for the Preservation of National Defense and State Security” (“Strategic Law”), however, requirements in relation to limitations of foreign capital and citizenship of the manager and executive officers continued to apply until April 10, 2012, but after that there remained no limitations on foreign participation in Russian aviation organizations. The Strategic

⁴ An aviation enterprise is defined as a legal entity, regardless of its form and ownership, whose principal stated activity is commercial air carriage of passengers, baggage, freight and mail, and/or carrying out aviation works.

⁵ An aviation organization includes an aviation enterprise and is defined very broadly as a legal entity, regardless of its form and ownership, whose principal stated activities are development, production, testing, operation, repair and/or recycling of aircraft and aircraft equipment.

Law does not impose limitations, but requires a foreign investor to obtain a prior approval of the Governmental Commission for Control over Foreign Investment in the Russian Federation or to provide a *post factum* notice to such commission if it acquires control over a legal entity engaged in any of the activities having strategic significance for the preservation of national defense and state security. All activities attributed to aviation organizations, except for aircraft operation, maintenance and repair of parts, modules and components carried out by civil aviation organizations and recycling of the aircraft and aircraft equipment, are among such activities. Thus, the acquisition of control by a foreign investor over a Russian company engaged in development, production, testing, operation and repair of aircraft and aircraft equipment, as well as aviation safety control, which also includes the acquisition of 50%⁶ or more of its share capital, requires prior approval of the Governmental Commission for Control over Foreign Investment in the Russian Federation. Acquisition of 5% or more of the share capital of such company requires a *post factum* notice.

In the WTO accession package, Russia has agreed to ease the restrictions on access by foreign participants to the domestic market in a number of industries. That also includes air transport services sector, namely, for off-service maintenance and repair of aircraft or aircraft parts (other than line maintenance and similar maintenance activities undertaken by airlines, including their agents or contractors). However, Russia managed to negotiate a grandfathering clause with respect to the restriction on foreign capital in such aviation organizations. Commercial presence of foreign participants on the Russian market for such activities will require establishment of a Russian legal entity, and the share of foreign capital in such aviation organizations established before the WTO accession may not exceed 50%.

Interestingly, the WTO accession package does not address foreign participation in Russian airlines. This is because airline operations (so-called “traffic rights” and any services directly related to them) are carved out from the WTO agreements on trade in services. Thus, the restrictions on foreign participation in Russian airlines will also survive accession to the WTO.

In summary, after the WTO accession, the following restrictions apply to investments in the Russian aviation sector:

⁶ A lower threshold of 25% is applicable when acquiring party is a foreign state, an international organization or their affiliates.

- An airline may be established or participation in an airline may be acquired only if (a) the participation share of foreign capital does not exceed 49% of its charter capital, (b) its head is a Russian citizen and (c) the number of foreign citizens in its management body does not exceed one third of its total number;
- Participation share of foreign capital in an existing company established before April 10, 2012, engaged in off-service maintenance and repair of aircraft or parts (other than line maintenance and similar maintenance activities undertaken by airlines, including their agents or contractors) may not exceed 25%;
- Prior approval of the Governmental Commission for Control over Foreign Investment in the Russian Federation under the Strategic Law is required in relation to establishment or acquisition of participation share exceeding 50% or more of the charter capital of a company engaged in development, production, testing and repair of the aircraft and aircraft equipment or aircraft safety control; and
- *Post factum* notice to the Governmental Commission for Control over Foreign Investment in the Russian Federation under the Strategic Law is required in relation to establishment or acquisition of participation share exceeding 5% or more of the charter capital of a company engaged in development, production, testing and repair of the aircraft and aircraft equipment or aircraft safety control.

OVERFLIGHT FEES

The Russian Federation levies overflight fees (also known as “royalties”) on non-Russian airlines for the use of Trans-Siberian routes in Russian airspace. Since Soviet times, the proceeds of these fees have been passed on to the Russian flag carrier Aeroflot. Aeroflot now continues to receive these payments pursuant to various pooling agreements with foreign airlines.

Certain Aeroflot competitors have claimed that the payment of these overflight fees to Aeroflot distorts competition. In addition, the Russian Government and Aeroflot have encountered international pressure, particularly from the European Union, to abolish the levy of these overflight fees on the grounds that they are anti-competitive. The European Commission finally managed to link this issue to the negotiations on Russia’s WTO accession and reached an agreement with the Russian Government on cancellation of all overflight payments not later than December 31, 2013 as a prerequisite for Russia’s

accession to the WTO. Beyond that date, foreign airlines will only pay air navigation charges,⁷ which must be cost-related and transparent.

It has been reported that by an agreement in the form of exchange of letters between the Russian Ministry of Economic Development and the European Commission Russia has confirmed its commitment to abolish overflight fees on the above terms, but this agreement is not yet publicly available. However, the status of this agreement is not clear and, according to state officials of the Russian Ministry of Economic Development, its implementation is temporarily postponed until the revision of the European Union emissions trading scheme.

TYPE CERTIFICATION

Type certification of aircraft for use in Russia is currently under the supervision of the Interstate Aviation Committee (the "IAC"). IAC is a supranational executive body of 12 former USSR republics (all but the Baltics), which has been delegated with certain functions in civil aviation pursuant to the Intergovernmental Agreement on Civil Aviation and Air Space Use, signed on December 30, 1991. IAC is not formally subordinated to any Russian authority.

IAC certifies aircraft types in accordance with Russian domestic aviation rules and regulations (such as AP-21 Aircraft Certification Procedures approved by the Russian Ministry of Transport in 1994), in addition to EASA and FAA certification. Thus, all aircraft (produced in Russia or elsewhere) must first be type certified by IAC before they can enter the Russian market. As a result, foreign aircraft manufacturers must incur additional costs for certification of the aircraft under Russian regulations, and Russian operators may not promptly acquire modern Western aircraft. Some WTO members also argued that the process of civil aircraft certification by the IAC lacked transparency and predictability, which raised concerns among aircraft manufacturers.

In connection with WTO accession, Russia provided assurance that Russian civil aircraft certification requirements and conformity assessment procedures will comply with all relevant provisions of the WTO agreements. In particular, these civil aircraft requirements would be prepared, adopted and applied in a non-discriminatory manner and will not be more restrictive than necessary. In addition, certification procedures will apply equally to all aircraft, regardless of origin, and will be performed in an expedited and transparent

⁷ The Federal Antimonopoly Service since 2008 recommended that the overflight fees were changed into air navigation charges which were to be paid not to Aeroflot, but to Russian aviation authority (currently – the Federal Agency of Air Transport).

manner. Certification fees will be imposed equitably whether the aircraft type is produced by a Russian or a foreign manufacturer.

Taking into the account the above, the WTO accession did not result in substantial immediate changes in the aviation sector: significant changes to the customs duty rate will occur in several years, subsidies are available only for the leasing of certain regional aircraft, foreign investments in Russian airlines are still restricted, and the type certification procedure and replacement of overflight fees with air navigation fees are yet to be discussed. However, the WTO can be seen as a positive step in the liberalization of trade with Russia in the aviation sector.

* * *

Please do not hesitate to contact us if you have any questions or wish to discuss the commitments of the Russian Federation in the aviation sector in greater detail.

December 6, 2012

Summary chart of customs rates applicable to aircraft imported to the Russian Federation

Weight (kg)	Aircraft Specification						Year of implementation
	Passenger				Cargo		
	P≤19	19<P≤50	50<P≤300	P>300	With CR	Without CR	
BOW≤2,000	20%→10%				20%→15%		2019 for passenger 2017 for cargo
2,000<BOW≤15,000	0% ¹ →8%	0%→8%	20%→8%				2017
15,000<BOW≤20,000	0% ¹ →7,5% ³ /12,5%		20% → 7,5% ³ /12,5%				2016 ³ /2019
20,000<BOW≤90,000	20% → 7,5% ³ /12,5%		20% ² →7,5% ³	0%→7,5% ³	20%→7,5% ³ /12,5%		2016 ³ /2019
90,000<BOW≤120,000			/12,5%				/12,5%
BOW>120,000	0%→7,5% ³ /12,5%						
MTOW>370,000	Not applicable				20%	0%	Not applicable

Legend:

BOW – basic operating (unladen) weight

MTOW – maximum take-off weight

P – number of passenger seats

CR – cargo ramp

¹ Such aircraft are exempt from both the customs duty and VAT if they are owned by foreign persons, used in the territory of the Customs Union of the Russian Federation, Republic of Belarus and Republic of Kazakhstan beyond the commercial schedule, not for profit, and the temporary import period does not exceed 30 consecutive days or 180 days in aggregate in the course of the calendar year.

² Such aircraft are exempt from both customs duty and VAT if their passenger seat capacity is between 111 and 170 or between 219 and 300.

³ Special rates applicable to wide-body, long range civil (passenger or cargo) aircraft.